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Tax Policy - Past, Present, and Future

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TAX POLICY—PAST, PRESENT, AND FUTURE[†]

Charles O. Galvin*

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I. INTRODUCTION

THANK you Mr. Dean Rogers. Members of the faculty, students, visitors, distinguished guests, ladies and gentlemen:

As some of you may be aware, I grew up just a few blocks from here on McFarlin Boulevard and have been associated with SMU on and off for many years. In fact, when people ask how I began my association with the University, I tell them that I was left on the steps of Dallas Hall as a foundling, someone took me in out of the cold, and I have been coming in and out ever since.

I was a freshman undergraduate in the college in the Fall of 1936. That was a year of celebration for the University and probably one of the significant times when the football team made a major contribution to the academic health of the institution, for on January 1, SMU had played in the Rose Bowl.¹ The proceeds from that game were used to make up back pay for faculty and staff who had been subject to salary cuts in the depression when the University ran out of money.²

Although I started law school here, my studies were interrupted for about four years by service in the United States Navy during World War II, and I finished my Juris Doctor degree at Northwestern. Later, I joined the SMU law faculty and continued that association for thirty years, fifteen of which I was the dean. Accordingly, this is a delightful return visit for me, and I extend my very sincerest thanks to all of you—dean, faculty, staff, students, and friends—for the opportunity to be here.

For the information of those of you who are Hatton W. Sumners Scholars, I had the great honor of working with Mr. Sumners after he had retired from Congress. He had an office in Storey Hall, and I assisted him in the drafting of his will, which left his estate to the Sumners Foundation, from which was created the Sumners fellowship program.

II. TAX POLICY IS FRONT AND CENTER STAGE

My assignment for today is tax policy, past, present, and future. On our agenda of national debate, the subject is as controversial and highly emotional as any that we could select. Our country's platter is filled with difficult issues, whether it be abortion, crime in the streets, gun control, juvenile delinquency, education policy, health care, welfare reform, or any one of many others. We have a stack of problems before us as a nation; yet nothing pervades and permeates so much of our discussion as

1. Score, January 1, 1936, Stanford, 7—SMU, 0.

2. In the mid-1930s the University reduced the last four out of ten paychecks by fifty percent and repeated this action in the following year. The proceeds from the Rose Bowl were about \$100,000.

the subject of taxation, because it affects us all. We are all taxpayers, and we have many different views about how the system should be administered. Indeed, within any group there would be as many different ideas about fair and equitable taxation as there are people present.

In this particular time of tax history in the United States, it is useful to examine in depth how we got from past to present before we take the steps from present to future. Particularly in these days of heated national debate about taxation, a long look backward may be as helpful as a long look forward.

III. TAX POLICY—THE PAST

A. THE BEGINNINGS

From 1789 until 1913, we relied primarily on import duties and excises to fund the cost of our national government.³ Our country constitutionally began its life as of 12:01 a.m. on March 4, 1789. The House and Senate were organized, and the House Ways and Means Committee—which is the tax writing committee of the House from which all tax bills must originate in accordance with our Constitution⁴—had already begun its deliberations even before General Washington made his way from Mount Vernon to Federal Hall, New York, to take the oath as the first President of the United States on April 30, 1789.⁵ Thereafter, we began our presidential terms on March 4, the anniversary date of the official beginning of the country, until we changed that date by constitutional amendment in 1933 so that the House and Senate are now organized on January 3 and the President is sworn in on January 20.⁶

B. THE CIVIL WAR

In 1864, during President Lincoln's administration, a modest income tax was enacted to fund the cost on the Union side of prosecuting the Civil War. This tax was continued with various amendments until it was repealed in 1872 during the first administration of President Grant.⁷ When the tax was repealed, the Commissioner of Internal Revenue refunded the money to the states from which it had been collected, perhaps a first instance of revenue sharing, or block grants, in our national policy. The Civil War income tax was challenged in *Springer v. United States*,⁸ which established, at least for that time, its constitutionality.

3. See Randolph E. Paul, *History of Taxation in the United States*, in *THE HISTORY AND PHILOSOPHY OF TAXATION* 5, 5-7 (Conference Papers, College of William and Mary, 1955).

4. U.S. CONST. art. I, § 7.

5. 1 *THE AMERICAN HERITAGE PICTORIAL HISTORY OF THE PRESIDENTS OF THE UNITED STATES* 46 (Kenneth W. Leish ed., 1968) [hereinafter *AMERICAN HERITAGE*].

6. U.S. CONST. amend. XX (ratified January 23, 1933).

7. See Walter J. Blum & Harry Kalven Jr., *The Uneasy Case for Progressive Taxation*, 19 *U. CHI. L. REV.* 417, 427 (1952).

8. 102 U.S. 586 (1880).

C. THE FISCAL TRAVAILS OF THE CONFEDERACY

Civil War buffs often engage in suppositions of "what ifs," such as what if Lee had not committed so much force at Gettysburg, what if Jubal Early had not turned back in his assault on Washington, and what if the South had been more disciplined and determined in the management of its fiscal affairs so that it could have maintained its creditworthiness with its European suppliers in order to continue to provide the materiel of war. The Confederacy was disadvantaged, however, because of the philosophy of its origins: it was a confederation of states whose rights were paramount. Therefore, by definition the central government was weak, and it was not possible for President Davis, Secretary of State Judah Benjamin, and Secretary of the Treasury Christopher Memminger to extract from the states the necessary revenue to curb inflation, maintain a high level of credit, and obtain the necessary resources to continue the war.⁹

There are other what ifs, such as what if the war had continued another several months. Both sides were overwhelmed by the hemorrhaging of blood and might have sought an end to it all. Even if the South had maintained its fiscal soundness, however, it would have had difficulty in bringing goods through the Union blockade, which would have raised other suppositions: what if arms had been transhipped through Mexico or Central America, through Texas or through the Gulf. These are interesting speculations in passing; nevertheless, the final result of that conflict was and is as it should have been.

D. PRE-SIXTEENTH AMENDMENT POLITICS

1. *The Wilson Tariff Act*

In 1894, during the second administration of President Cleveland, the Wilson Tariff Act provided for an income tax.¹⁰ There was as much controversy and emotional tension about that legislation as there is about any of the major issues we have before us today.¹¹ The tax was immediately challenged in *Pollock v. Farmers' Loan & Trust Co.*,¹² and despite the earlier *Springer* case, a sharply divided Supreme Court invalidated the tax.¹³ It became necessary, therefore, to submit the issue by constitu-

9. See generally HUDSON STRODE, JEFFERSON DAVIS (1964).

10. Blum & Kalven, *supra* note 7, at 423.

11. RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 32-39 (1954).

12. 157 U.S. 429 (1895), 158 U.S. 601 (1895). In an unusual procedural maneuver the case went forward to the Supreme Court through the process of injunction.

13. *Pollock*, 157 U.S. at 451. The controversy over the Court's decision waxed loudly all over the country:

The *New York Tribune* felt that victory had been eternally won, saying: "The great compromises which made the Union possible still stand unshaken to prevent its overthrow by communistic revolution. The fury of ignorant class hatred, which has sufficed to overturn absolute power in many other lands, and even now renders the maintenance of a government of law uncertain in some, has dashed itself in vain against the Constitution of the United States, fortified by the institutions which a free people have established for the de-

tional amendment to the states through the Sixteenth Amendment,¹⁴ which was first ratified by Alabama.

Alabama, like other states in the former Confederacy, was still recovering from Reconstruction. Generally, the South and the West were the debtor states, and as far as their people were concerned they had little income, and they felt that the rich Yankees should pay the tax. Moreover, a new tax system could ease the burden of manufacturers' excise taxes which fell heavily on the South and the West. Thus, there was both economic and political reason for favoring the tax in one region and opposing it in the other.¹⁵

Who sponsored the Sixteenth Amendment and supported its ratification? Some might suppose that it was the liberal Democrats, but it was the Republicans under the leadership of two very able Republican Presidents, Theodore Roosevelt and William Howard Taft.

2. Roosevelt and Taft

Roosevelt had been active in Republican politics in the State of New York. He served in the State Assembly and was governor of the state, but he was never popular with the leaders of the Republican establishment, and they wanted to get rid of that "wild-eyed cowboy."¹⁶ Accordingly, the party regulars decided to send him to Washington to be vice-president, a position then regarded as a dead-end street; and in the Republican Convention of 1900 the New York delegation persuaded President McKinley to select Roosevelt as his running mate.¹⁷

In his first term, President McKinley had had a distinguished vice-president, Garret Hobart, a Republican from New Jersey. He was highly respected from both sides of the political aisle, was a constant advisor to President McKinley, and was admiringly spoken of in the press of that

fense of their rights [T]he Supreme Court . . . has grandly vindicated itself and added incalculably to the regard in which its decisions are held."

On the other side, the radical *New York World* characterized the decision as a "triumph of selfishness over patriotism" and "another victory of greed over need." It complained bitterly: "Great and rich corporations, by hiring the ablest lawyers in the land and fighting against a petty tax upon superfluity as other men have fought for their liberties and their lives, have secured the exemption of wealth from paying its just share toward the support of the government that protects it If the Constitution really prevents equal and just taxation the people can amend their Constitution. And they will!"

PAUL, *supra* note 11, at 62-63.

14. U.S. CONST. amend. XVI (ratified February 3, 1913).

15. Paul, *supra* note 3, at 6.

16. Following the deaths of his mother and his first wife, Alice, Roosevelt went to the Badlands in the Dakota Territory where he gained the respect of the ranch hands with whom he could ride herd as well as any seasoned cowboy. The appellation as a cowboy stuck. When he took office following President McKinley's assassination, Mark Hanna, Republican National Chairman, was heard to say: "Now look, that damned cowboy is President of the United States." 2 AMERICAN HERITAGE, *supra* note 5, at 626.

17. *Id.* at 625-27. There are many excellent biographies of Theodore Roosevelt; a recent one covering the Theodore and Franklin families is PETER COLLIER WITH DAVID HOROWITZ, *THE ROOSEVELTS: AN AMERICAN SAGA* (1994).

day as Mr. Assistant President.¹⁸ Vice-President Hobart died about half-way through the first McKinley Administration,¹⁹ so the office remained vacant because there was not then the constitutional amendment which permits the President to fill the vacancy.²⁰ The position being open, President McKinley selected Roosevelt as his running mate. The Democrats had selected their silver-tongued orator, William Jennings Bryan, in 1896 and selected him again in 1900; he lost for the second time.²¹

McKinley and Roosevelt took their oaths of office on March 4, 1901, and within six months McKinley was dead from an assassin's bullet in Buffalo, New York.²² Roosevelt served out most of the McKinley term, was elected on his own merits in 1904, and in the Republican Convention of 1908 actually hand-picked his successor, William Howard Taft.²³ The Democrats nominated Bryan for the third time, and again Bryan lost.²⁴

Following the inauguration of President Taft in March 1909, Roosevelt went on a big game hunting expedition in Africa. The comments of some of the New York Republicans indicate the bitter acrimony and hostility they felt about him over tax and economic issues. Roosevelt had addressed the country about such unmentionables as workers' rights, social security, universal healthcare, a corporation income tax, and a personal income tax, and he had also mentioned the possibility of a national inheritance tax to break up the fortunes of the super rich. In this connection he was far more caustic in references to those to whom he referred as the malefactors of great wealth than his Democratic cousin Franklin was in the 1930s.

When J. Pierpont Morgan, one of the New York Republican old guard, who had participated in removing Roosevelt from New York, heard of the hunting expedition, he said that he hoped that the lions would enjoy a good dinner some evening.²⁵ Morgan and his allies had been involved in the famed *Northern Securities* case,²⁶ Roosevelt had undertaken to enforce the Sherman Anti-Trust Act against them, and the Supreme Court sustained the administration.²⁷ No wonder that Morgan was ready to feed the President to the lions.

18. 2 AMERICAN HERITAGE, *supra* note 5, at 601.

19. *Id.*

20. U.S. CONST. amend. XXV (ratified February 10, 1967).

21. 2 AMERICAN HERITAGE, *supra* note 5, at 617.

22. *Id.* at 618-19.

23. *Id.* at 664.

24. Popular vote: Taft, 7,675,320; Bryan, 6,412,294. Electoral vote: Taft, 321; Bryan, 162. *Id.* at 681. Bryan served as President Wilson's Secretary of State, but resigned in 1915 when he saw the possibility of the United States becoming involved in World War I. He believed that the role of the United States should be to use diplomacy to stop the war, not to become involved in it. *Id.* at 617.

25. Various quotations are ascribed to Morgan on this occasion, such as his hope that "every lion would do his duty." COLLIER, *supra* note 17, at 154. Roosevelt's response a few years later could have been that it was too bad that J. P. Morgan cancelled his reservations on the Titanic.

26. *Northern Sec. Co. v. United States*, 193 U.S. 197 (1904).

27. See COLLIER, *supra* note 17, at 113-114.

The Taft Administration continued the policies of the Roosevelt Administration and sponsored the corporation income tax of 1909, which was sustained constitutionally in *Flint v. Stone Tracy Co.*²⁸ as an excise tax. The Taft administration also sponsored the Sixteenth Amendment²⁹ and sent it to the states for ratification, which was completed in February of 1913. Despite these achievements, Taft and Roosevelt developed serious differences, and their rift became so deep that no reconciliation was possible. In 1912 Roosevelt formed the Progressive Republicans, or Bull Moose Party.³⁰ Taft was nominated by the Republican regulars, thus creating the interesting scene in American history of two Republican presidents—Roosevelt, the former president, and Taft, the sitting president—running against each other, all of which made possible the election of one Thomas Woodrow Wilson, who received a minority of the popular vote but a majority of the electoral votes.³¹

Following their defeat, Roosevelt went on an expedition on the Amazon River and contracted there an illness that probably claimed his life.³² Taft accepted a professorship at the Yale Law School.³³ He was popular with the students, made his early classes along with others, and, probably like all law professors, turned in the grades on his blue books late. By present standards he was not photogenic or telegenic. Weighing about 350-375 lbs., he was usually in rumpled, disheveled clothes, appearing like a large walk-around, unmade king-sized bed. He had been a professor and dean at the University of Cincinnati Law School before he became President.³⁴ One can only imagine today a dean of a law school becoming President of the United States. In 1921 President Harding appointed Taft to be Chief Justice of the United States, a position he had always wanted;³⁵ and so far he is the only man in history to be President and Chief Justice.

3. *The Wilson-Hughes Contest*

In 1916 the Progressive Republicans again wanted Roosevelt to run, but he declined and the regulars called on one of their superstars, Charles Evans Hughes.³⁶ He had also been governor of New York, and in 1909 President Taft had appointed him Associate Justice of the Supreme Court.³⁷ He was persuaded to resign from the Court and run for President. Roosevelt did not particularly like Hughes, referring to him as the

28. 220 U.S. 107 (1911).

29. U.S. CONST. amend XVI (ratified February 3, 1913).

30. 2 AMERICAN HERITAGE, *supra* note 5, at 655.

31. Popular vote: Wilson, 6,296,547; Roosevelt, 4,118,571; Taft, 3,486,720. Electoral vote: Wilson, 435; Roosevelt, 88; Taft, 8. *Id.* at 721.

32. *See* COLLIER, *supra* note 17, at 174-79, 240-41.

33. He was offered the Kent Chair of Constitutional Law; he said he could not accept a chair, but a sofa would be fine. 2 AMERICAN HERITAGE, *supra* note 5, at 668.

34. *Id.* at 680.

35. *Id.* at 679.

36. *Id.* at 711.

37. *Id.*

"bearded lady," but he liked Wilson even less, so he actively supported Hughes.³⁸ It was a close campaign, decided by California in the early hours of Wednesday morning, with a slim 5000-vote margin in Wilson's favor.³⁹ Wilson for the second time received a minority of the popular vote in the country at large.⁴⁰ In 1930 President Hoover appointed Charles Evans Hughes as Chief Justice of the United States;⁴¹ thus, each of the two defeated Republican candidates for the presidency was subsequently appointed as Chief Justice.

E. THE FIRST INCOME TAX

The first individual income tax became effective during the Wilson Administration as of October 3, 1913,⁴² but was made retroactive to March 1, the first day of the first month following the ratification of the Sixteenth Amendment.⁴³ Taxable income was defined as gross income less specified deductions, such as business expenses, interest, state and local taxes, losses, bad debts, and depreciation.⁴⁴ Credits were allowed for dividends received from taxable corporations and for taxes paid on income at the source.⁴⁵ Exemption deductions were allowed at \$3000 for unmarried and \$4000 for married persons in computing the normal tax of one percent.⁴⁶ Graduated surtaxes were levied on income in excess of \$20,000.⁴⁷

F. THE WEALTH TRANSFER TAXES

In 1916, during the Wilson Administration, the first estate tax was enacted,⁴⁸ a tax on the privilege of transferring property from the dead to the living. The tax was largely avoided by the wealthy, who with the advice of their gaggle of bright lawyers could transfer property in trust during lifetime yet retain the benefits. Accordingly, in order to provide a back-stop for the estate tax, Congress during the administration of President Hoover enacted a gift tax effective from June 6, 1932.⁴⁹

38. COLLIER, *supra* note 17, at 186-87.

39. 2 AMERICAN HERITAGE, *supra* note 5, at 695.

40. Popular vote: Wilson, 9,127,695, Hughes and others, 9,339,126. Electoral vote: Wilson 277; Hughes, 254. *Id.* at 721. Reporters went to Hughes' home in Washington in the early hours of Wednesday morning to get a statement from him. His manservant announced that the "President" had retired and that the "President" would have a statement later in the morning. Some irreverent reporters shouted to wake up the President and tell him he was no longer President. *Id.* at 695.

41. *Id.* at 711.

42. Income Tax Act of Oct. 3, 1913, Pub. L. No. 16, ch. 16, § 2, 38 Stat. 166-68.

43. *Id.* Despite current criticism of the retroactivity of tax statutes, most of them have had retroactive features since the 1913 Act.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. Estate Tax Act of September 8, 1916, Pub. L. No. 271, §§ 200-12, ch. 463, 39 Stat. 777-80.

49. Gift Tax Act of June 6, 1932, Pub. L. No. 154, ch. 209, §§ 501-32, 47 Stat. 245-59. There was a gift tax for a brief period (1924-1925) during the administration of President

Although the estate and gift tax system was sufficient for most wealth transfers, there remained a gap generally benefitting the wealthy in their use of dynastic trusts. Pursuant to these arrangements, grandparents could create a trust for children for life, then grandchildren for life, then great-grandchildren with remainders over.⁵⁰ Although a wealth transfer tax might be incurred on creation of the trust, the next transfer tax liability could be over a hundred years later. The Tax Reform Act of October 22, 1986,⁵¹ signed by President Reagan, provided for a flat fifty-five percent generation-skipping transfer tax that was intended to assure that wealth transfers are taxed each generation.⁵² Thus, if grandmother makes a Christmas gift, a birthday gift, or a graduation present to granddaughter, and grandmother has already used up her specific exemption and annual exclusion, the tax from the first dollar is fifty-five percent,⁵³ and in addition, she will have to pay a gift tax which also can be as high as fifty-five percent,⁵⁴ so that the total of the two taxes can exceed one hundred percent of the value of the gift.

G. BIPARTISANSHIP IN TAX POLICY

The above chronology demonstrates that both political parties have participated in effecting increases and decreases in taxes to meet the exigencies of the time; other examples follow.

1. *The 1962 and 1964 Acts*

Two significant tax reduction bills were the Revenue Acts of 1962⁵⁵ and 1964,⁵⁶ the former passed by a Democratic majority during the Kennedy Administration and the latter by a Democratic majority during the Johnson Administration. The 1964 Act reduced the top rates from ninety-one percent to seventy percent and the bottom rate from twenty percent to fourteen percent.⁵⁷ In the 1962 Act, rules were introduced with respect to the investment tax credit,⁵⁸ a direct dollar-for-dollar credit available to

Coolidge. For historical comments see JOSEPH A. PECHMAN, *FEDERAL TAX POLICY* 236 (5th ed. 1987); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539 (1993); David M. Hudson, *Tax Policy and the Federal Taxation of the Transfer of Wealth*, 19 WILLAMETTE L. REV. 1, 9-32 (1983); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994).

50. If O leaves Blackacre to his son A outright, and A leaves Blackacre to his son B outright, there is a transfer tax at each death; but if O leaves Blackacre in trust for A for life and then to B, A may enjoy all the benefits of Blackacre but there is no estate tax at A's death.

51. Pub. L. No. 99-514, 99 Stat. 514 (codified in scattered sections of 19, 25, 26, 28, 29, 42, 46 and 49 U.S.C.).

52. *Id.* (repealing *ab initio* I.R.C. ch. 13, first introduced in 1976, and substituting a new generation-skipping transfer tax).

53. I.R.C. §§ 2641, 2001 (1988).

54. I.R.C. § 2515 (1988).

55. Revenue Act of Oct. 16, 1992, Pub. L. No. 87-834, 76 Stat. 960.

56. Revenue Act of Feb. 26, 1964, Pub. L. No. 88-272, 78 Stat. 19.

57. *Id.* § 111, 78 Stat. 19-21 (amending I.R.C. § 1).

58. Revenue Act of 1962, § 2, 76 Stat. 962-70 (adding I.R.C. §§ 38, 46, 47 and 48).

those taxpayers who invested in new plants, new facilities, new productive capacity—pristine, pure supply-side economics, pure Reaganomics, even before that term was coined, passed in the Kennedy and Johnson Administrations.

2. *Blueprints for Basic Tax Reform*

In 1977 the Treasury Department published what has become a seminal work in any formal study of tax policy: *Blueprints for Basic Tax Reform*,⁵⁹ sponsored by a conservative, Republican Secretary of the Treasury William E. Simon, who served under President Ford.⁶⁰ That study contained suggestions for taxing capital gains as ordinary income,⁶¹ eliminating deductions that would benefit upper-income taxpayers,⁶² and other base-broadening measures.

3. *The Reagan Period*

Seven years later, in 1984, President Reagan called on his Secretary of the Treasury, Donald Regan, another conservative Republican, to prepare proposals for major tax reform. The document, *Report to the President: Tax Reform for Fairness, Simplicity and Economic Growth*,⁶³ proposed broadening the base and lowering rates. It also called for taxing capital gains as ordinary income, eliminating certain personal deductions that would benefit upper-income taxpayers, and repealing benefits for certain industries, including the oil and gas industry.⁶⁴ When this document reached the White House, however, it was deemed too visionary and was sent back to the Secretary to be toned down. This led to a revised product, Treasury II, or Reagan I,⁶⁵ which was adopted by the President and became the forerunner of the Tax Reform Act of 1986.⁶⁶ That act broadened the base, lowered rates, eliminated tax shelters and denied certain personal deductions beneficial to upper-income taxpayers. It was a bipartisan effort of Republicans and Democrats and supported by President Reagan.

59. U.S. DEP'T OF TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM* (Tax Analysts ed. 1977) [hereinafter *BLUEPRINTS*].

60. "[W]e need to wipe the slate clean of personal tax preferences, special deductions and credits, exclusions from income and the like. . . . It must be a system that is designed on purpose." *BLUEPRINTS*, *supra* note 59, at xxi.

61. *Id.* at 71.

62. *Id.* at 79.

63. U.S. DEP'T OF TREASURY, *REPORT TO THE PRESIDENT: TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH* (1984).

64. *Id.* at vol. 2, ch. 11.

65. *PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY* (1985).

66. Tax Reform Act of Oct. 22, 1986, Pub. L. No 99-514, 99 Stat. 514 (codified in scattered sections of 19, 25, 26, 28, 29, 42, 46 and 49 U.S.C.). For an excellent account of events leading to the Tax Reform Act of 1986, see JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* (1987); see also EUGENE C. STEUERLE, *THE TAX DECADE* (1992).

4. *Bush and Clinton*

President Bush suffered politically by supporting an increase in taxes; yet I think he acted responsibly in doing so. President Clinton also suffered from his support of the tax bill of 1993, but I think he, too, acted responsibly. Thus, both parties over time and history have responded to the exigencies of the moment in enacting increases or decreases in taxes.

IV. BUDGET OUTLAYS

Any examination of tax policy must deal with the level of expenditures. The growth in outlays is dramatic. The budget exceeded \$50 billion in the administration of President Truman, \$100 billion with President Kennedy, \$200 billion with President Nixon, \$500 billion with President Carter, and \$1 trillion with President Reagan.⁶⁷ The budget for the year ending September 30, 1995, is set at \$1 trillion, 500 billion, and for fiscal 1996, over \$1.6 trillion is proposed.⁶⁸ The national debt is now over \$5 trillion.⁶⁹

Any inquiry as to the purposes for which this \$1 trillion, 500 billion is spent would evoke responses to the effect that it goes for all kinds of wasteful expenditures—food stamps, tuition loans that students do not repay, subsidies for agriculture, and various welfare payments. The facts, however, are otherwise.

A. THE THREE MAJOR EXPENDITURES

Out of the total budget dollar about forty-seven percent is expended for social security, twenty-two percent is for national defense, and fourteen percent is for interest. Thus, eighty-three percent of the budget outlay is for three big-ticket items: social security (including Medicare), national defense, and interest on the national debt.⁷⁰

1. *Social Security*

Social security payments are described as entitlements or transfer payments; those in the workforce pay in a certain portion of their monthly pay which is then transferred to those who receive benefits. If the receipts and outlays were at the same rate, the situation would not be critical. The nation is progressively becoming older, however, so that proportionately there are more recipients than contributors as compared with ten or twenty years ago. Total social security payments continue to rise; therefore, to finance the program, younger people in the work force may have to sustain greater reductions in pay and will not be able to claim the benefits at the same age as the present retirees. Retirees may

67. ECONOMIC REPORT OF THE PRESIDENT, H. R. DOC. NO. 178, 103d Cong., 2d Sess. 359 (1994).

68. *Id.* at 361.

69. *Id.* at 359.

70. *Id.* at 361.

have to forego cost of living increases and pay higher taxes on amounts received.

2. *Defense*

Members of Congress from Texas, both Republicans and Democrats, state that it is appropriate to close the Philadelphia Navy Yard, which, they say, is obsolete, or that it is appropriate to close the submarine base at New London, Connecticut and consolidate the work at the Boston Navy Yard. On the other hand, members of Congress from Connecticut or Pennsylvania may attest that money is wasted in Texas and California on air fields and defense industries. Texas has the third largest number of military installations in the nation and a community-by-community mobilization has been organized to present the best arguments why the military should look somewhere else for budget cuts.

Should we have more stealth bombers or less? Should we spend more on nuclear submarines? Members of Congress from both political parties argue on different sides of these issues even within their own ranks. What seems clear is that, while the prospect of reducing national defense expenditures is unlikely, the prospect that they may be increased is very real.

3. *Interest*

Interest on the national debt, the third major item, is simply a function of the money market. We owe \$5 trillion and will soon owe \$6 trillion.⁷¹ The government must pay what the market requires to obtain the necessary funds. A nightmare for the Secretary of the Treasury could be one in which the Japanese holders of our national debt call in their funds. This will not happen because the money the Japanese lend to us is returned in the purchase of Japanese products. But when we get tough on the Japanese about exports and imports, they might say that they have problems of their own to deal with and can no longer be relied upon as willing creditors. What is true of the Japanese holders of our national securities could apply to Germans, Saudis, Canadians, and others. The argument is often heard that the national debt is simply money we owe each other within the country, but that is not the case. To be sure, at one time the debt was held within our borders when we were a major creditor in the international money market; however, we are now a major debtor in that market.

These three big-ticket items are eighty-three percent of the budget. The rest of the cost of the federal government is paid out of seventeen cents on the budget dollar: the executive departments, the Congress, the courts, the subsidies to farm products, the maintenance of such facilities as the coast and geodetic survey, the national forests, the national parks,

71. *Id.* at 359.

and many others.⁷² In the recent commission headed by Senators Kerrey of Nebraska and Danforth of Missouri,⁷³ the prediction was made that we must do something about these major items, or by the year 2012 all the revenue received will be just enough to cover social security and interest on the debt.⁷⁴ It is obvious that there is pain ahead for everyone.

V. TAX MODELS FOR FUTURE REVENUES

Whatever the allocation of our expenditures, how do we raise over \$1 trillion, 500 billion to cover them? There are two models of tax policy that are basic to any consideration of how to obtain the necessary revenues. The Haig-Simons model may be more generally described as the Comprehensive Income Tax system; the other is the Cash Flow, or Consumed Income, model. All research on tax reform begins with these models.⁷⁵

Comprehensive Income is an amount equal to the difference—plus or minus—in the taxpayer's net worth between the beginning and the end of the accounting period, plus the amount spent for consumption.⁷⁶ Consumed Income is an amount which is equal only to that spent on consumption; what the taxpayer holds in investment or savings and all income, gains, and losses therefrom are excluded.⁷⁷

A. THE COMPREHENSIVE MODEL

A taxpayer filing under a comprehensive model would add to adjusted gross income unrealized gains and losses from investments, including all the income, gains, and losses in various sheltered accounts such as IRAs and 401k or 403b accounts, plus any gifts and inheritances received. The taxpayer would take no deductions for personal expenditures, such as contributions, medical expenses, interest on home mortgages, or real estate taxes on the home. If taxable income were determined in this manner, the taxable base for middle and upper income groups would, of course, be higher.

What about lower income groups? Based on statistics with respect to 1992 returns, over eighty percent of filers have adjusted gross incomes under \$50,000, which consist principally of wages and salaries.⁷⁸ Filers in this group have little or no investments in capital and are not concerned about rents, royalties, dividends, capital gains, and retirement accounts.⁷⁹

72. *Id.* at 361.

73. See BIPARTISAN COMMISSION ON ENTITLEMENT AND TAX REFORM, INTERIM REPORT TO THE PRESIDENT 6 (1994).

74. *Id.*

75. An excellent summary of the two models may be found in Edward J. McCaffery, *Tax Policy under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992); see also BLUEPRINTS, *supra* note 59; Charles O. Galvin, *Tax Legislation in the Reagan Era—Movement To or From a Consumption Base?*, 48 LAW & CONTEMP. PROBS. 31 (1985).

76. HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

77. BLUEPRINTS, *supra* note 59, at 27-32.

78. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULL. 11 (Spring 1994).

79. *Id.*

Moreover, their deductions for contributions, mortgage interest, and real estate taxes are not large enough to itemize, so they rely on the standard deduction. Therefore, their tax base under a comprehensive system would remain about the same. To produce the same or greater revenue, the tax rates could be less progressive, perhaps even flat.⁸⁰

B. THE CONSUMED INCOME MODEL

A taxpayer filing under a consumed income model would begin with the expanded adjusted gross income described previously but would exclude all investments, income, and gains and losses from investments, thus leaving in the taxable base only those amounts used in consumption: food, clothing, housing, recreation, and other consumables. Investments and income therefrom that have been free of tax would become part of the taxable base only when taken out for consumption or when the taxpayer makes transfers by gift or at death.

For the lower income group previously described, whose principal income is from wages and salaries and which expends that income in consumption, the taxable base would remain about the same, but for middle and upper income groups there would generally be a reduction in the taxable base. The catch-up for upper income taxpayers occurs when they take money out of investment for consumption or transfer savings by gift or at death. Within two generations, the total income reported under either the comprehensive income or the consumed income model will be approximately the same, because under either model there is a final accounting for all income earned by the taxpayer during his or her lifetime. Under either model there would be no corporate tax⁸¹ and no estate, gift, or generation skipping transfer taxes.⁸²

80. See CHARLES O. GALVIN & BORIS I. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE?* 12-16 (1969). The concept of a flat tax has been the subject of recent review. See, e.g., Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987); Blum & Kalven, *supra* note 7; Richard L. Doernberg, *A Workable Flat Rate Consumption Tax*, 70 IOWA L. REV. 425 (1985); Alan L. Feld, *The Economic Recovery Tax Act of 1981: Fairness in Rate Cuts in the Individual Income Tax*, 68 CORNELL L. REV. 429 (1983); Michael J. Graetz, *The 1982 Minimum Tax Amendments as a First Step in the Transition to a "Flat-Rate" Tax*, 56 S. CAL. L. REV. 527 (1983).

81. BLUEPRINTS, *supra* note 59, proposed the integration of the corporate tax using a Subchapter S model. *Id.* at 69.

82. Even under the present system we could do without the estate tax. See, e.g., Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413 (1991); Robert B. Smith, *Burying the Estate Tax Without Resurrecting Its Problems*, 55 TAX NOTES 1799 (1992); Charles O. Galvin, *Burying the Estate Tax: Keeping Ghouls Out of the Cemetery: A Reply to Professor Smith*, 56 TAX NOTES 951 (1992); Charles O. Galvin, *More Reasons to Bury the Estate Tax*, 59 TAX NOTES 435 (1993); Lawrence A. Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361 (1993); Charles O. Galvin, *Taxing Gains at Death: A Further Comment*, 46 VAND. L. REV. 1525 (1993); Joseph M. Dodge, *Further Thoughts on Realizing Gains and Losses at Death*, 47 VAND. L. REV. 1827 (1994).

C. THE 1986 ACT

The 1986 Tax Reform Act⁸³ passed during the Reagan administration moved in the direction of a comprehensive model and was praised by tax professionals and commentators throughout the country, both conservatives and liberals, for that accomplishment.⁸⁴ The 1994 Republican Contract with America, however, proposes to move toward a consumed income model, including such components as flat or flatter rates generally, lower rates on capital gains, more generous depreciation allowances, and more generous treatment for contributions to savings accounts.

D. THE SEARCH FOR A HYBRID

Thus, we can expect no pure comprehensive model, nor can we expect a pure consumed income model. Our present system, which is a hybrid of the two models, will continue. Indeed, there is growing support among tax researchers for the proposition that a hybrid is the preferred system and that we ought to devote more attention in policy analysis to testing the economic efficiencies and inefficiencies of such a system. In this connection, there has been increased discussion about Pareto optimality,⁸⁵ the Kaldor-Hicks analyses, and the Mirrlees Model.⁸⁶ Those advocating such approaches are representative of social scientists who believe that the mathematical precision accomplished in the natural sciences can be applied to economics. Because of the advances in computer technology, there is now a developing school of thought which holds that we can indeed develop models that will reflect efficiencies and deficiencies in tax proposals as they affect allocation of resources in a free market economy.

VI. POLITICAL REALITY AND TAX REFORM

A. POLITICAL ACTION COMMITTEES

Will we do a careful and thoughtful analysis of tax proposals? Not very likely. Members of both parties in Congress are too influenced by political action committees (PACs), and there seems little likelihood that any reform of these arrangements is going to cut very deep. The contributions that are made to the PACs of members of the House Ways and Means Committee and the Senate Finance Committee exceed those made to the PACs of members of any of the other committees of the House or Senate. Indeed, it is accepted that the Ways and Means Committee and the Senate Finance Committee are, in fact, enriching committee member-

83. Tax Reform Act of Oct. 22, 1986, Pub. L. No. 99-514, 99 Stat. 514 (codified in scattered sections of 19, 25, 26, 28, 29, 42, 46 and 49 U.S.C.).

84. See Henry J. Aaron, *The Impossible Dream Comes True: The New Tax Reform Act*, BROOKINGS REV., Winter 1987, at 3.

85. HARVEY S. ROSEN, PUBLIC FINANCE 50-53, 57-61 (1985).

86. McCaffery, *supra* note 75, at 1155-57; Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1946-59 (1987).

ships. Members can accumulate substantial sums of money, which assist them in their campaigns for reelection.⁸⁷

B. LIMITED TERMS

Another issue on which there is considerable current debate is limited terms. People at work in the Congress, the executive offices, and the courts are employees of the citizenry as a whole. Sometimes, however, those inside the Beltway turn the institutional arrangements around and think that it is the citizens who are the employees. Why not put a limit on senators and congressmen as we have on the President? The President and many governors are limited to two terms; why not establish six two-year terms in the House and two six-year terms in the Senate as the limit? Furthermore, when congressmen and senators leave office, there should be strict proscriptions on hiring out as lobbyists with organizations that regularly appear before them.

I mentioned the majority of our fellow citizens who work from paycheck to paycheck. Who lobbies for them? Who is looking out for their subsidies, their allowances, their special preferences?

VII. THE FUTURE

Despite the political pressure to move rapidly in tax reform, it should be noted that there are efforts in both parties to effect change through critical investigation. I have already mentioned the Kerrey-Danforth Commission, a study project headed by Senator Kerrey, Democrat of Nebraska, and former Senator Danforth, Republican of Missouri.⁸⁸ Another project is headed by Senator Nunn, Democrat of Georgia, and Senator Domenici, Republican of New Mexico.⁸⁹ Two Republicans from Texas, Representative Dick Armey, the majority whip, and Representative Bill Archer, Chair of the Ways and Means Committee, as well as Representative Gephardt, Democrat from Missouri, are expected to propose different versions of a flat tax. Former Senators Tsongas, Democrat, and Rudman, Republican, have organized the Concord Coalition to propose major changes.

VIII. CONCLUSION

Every indication is that fundamental changes will occur. Simplification and fairness can be achieved in bipartisan fashion, but only with the most careful consideration of the two models that I have described, or a combination of them, with appropriate analysis of the resulting distribution of

87. See, e.g., Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 936-40 (1987).

88. See INTERIM REPORT TO THE PRESIDENT, *supra* note 73.

89. CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, STRENGTHENING OF AMERICA COMMISSION (1992); see explanation of Arney and Nunn/Domenici plans in Rachelle B. Bernstein et al., *Tax Reform 1995: Looking at Two Options*, 68 TAX NOTES 327 (1995).

income, distribution of resources within the economy, and the impact of change on the path of gross domestic product. The extent to which this heavy homework is done may be dictated by politics rather than logical and rational analysis.

Law students will have a profound influence on the future course and direction of national policy. The older generation is confident that they will influence that change by objective and dispassionate lawyerly analysis in keeping with law school training and the finest traditions of our profession.

